(13)

Nos. 739-740

In the Supreme Court of the United States

OCTOBER TERM, 1944

INTERNATIONAL STANDARD ELECTRIC CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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CITATIONS

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OPINIONS BELOW

The opinion of the Tax Court (R. 42–54) is reported in 1 T. C. 1153. The opinion of the Circuit Court of Appeals (R. 95–101) is reported in 144 F. 2d 487.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on September 9, 1944 (R. 102–105).[1] The petition for writs of certiorari was filed on

[1] This is the day that the "orders for mandate" issued (R. 102–105). The opinion of the court, affirming the orders of the Tax Court in part, and remanding the proceedings for recomputation of the tax because of the court's ruling as to

December 9, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, in determining "net income from sources without the United States" for purposes of the foreign tax credit limitation in Section 131 (b) of the Revenue Acts of 1936 and 1938, dividends from foreign corporations are to be subjected to deduction of a ratable part of such of the taxpayer's expenses as are not specifically allocable to any item or class of gross income.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in Appendix A, *infra*, pp. 11–18.

STATEMENT

The facts found by the Tax Court, so far as here pertinent, may be summarized as follows (R. 43–49):

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matters not here involved, was handed down on August 11, 1944 (R. 95–101). On the same day, the Clerk made the following docket entry with reference to these cases:

> August 11, 1944. Order modified, A. N. Hand, C. J. (The certificates of docket entries by the Clerk of the Circuit Court of Appeals for the Second Circuit have been lodged with the Clerk of this Court, and are printed in Appendix B, *infra*, pp. 19–20.)

Hence the question of the timeliness of the petition for a writ of certiorari which this Court is to consider in *Commissioner* v. *Bedford*, No. 710, this Term, is also involved in this case.

The taxpayer is an intermediate management and holding company in the International Telephone & Telegraph System. Most of the foreign sales and manufacturing units of the System were, in the tax years, subsidiary corporations owned by the taxpayer. With one exception, each of them was incorporated under the laws of the country in which it operates. None engages in business within the United States or has offices in this country. (R. 43–44.)

The taxpayer is not engaged in manufacturing, does not do business in any foreign country, and has no foreign branch or office. Under written contracts with its foreign subsidiaries, it provides management services, technical assistance, and patent, financial, and accounting information. In its New York offices, it employs experts, technicians, and clerks, who are informed about developments in the communications industry and correlate the work of the laboratories and the manufacturing and sales subsidiaries located abroad. Technical experts on the taxpayer's staff are loaned to subsidiaries at the latter's expense. For its managing services, the taxpayer charges its subsidiaries fees, usually computed on a percentage of sales basis, and it charges for patent privileges, royalties, and patent information. (R. 44.)

Gross income as shown on the taxpayer's income tax returns for 1937 and 1938 is as follows (R. 44–45):

	1937	1938
Gross profit from sales	$1,152,963.05	$1,082,320.62
Royalties	967,227.24	927,856.48
Contract revenue	381,343.23	507,550.24
Dividends from stocks of foreign corporations	3,764,682.81	5,609,585.47
Interest earned	290,427.64	364,624.96
Interest on obligations of the United States	425.00	425.00
Commissions	20,748.25	14,299.33
Capital gain or (loss)	83,589.61	(2,000.00)
Miscellaneous income	108,416.69	143,045.99
Profit realized on foreign exchange		95,501.91
Total	6,769,823.52	8,743,210.00

Deductions as shown on the taxpayer's income tax returns for 1937 and 1938 are as follows (R. 46):

	1937	1938
General and miscellaneous expense	$1,035,847.30	$1,025,177.97
Pension, sick and death benefits paid	122,964.58	80,488.30
Taxes, other than income taxes	79,148.93	77,523.02
Royalties, etc	861,300.27	930,848.19
Depreciation	2,803.46	1,052.46
Bad debts	557.19	10,946.54
Loss realized on foreign exchange	164,994.02	
Interest on funded debt		275,848.30
Interest on unfunded debt	337,745.34	404,732.85
Amortization of patents	588.17	1,448.92
Amortization of bond discount and expense		44,317.13
Total	2,606,009.26	2,852,383.68

The taxpayer's expenses were for the most part annually recurring operating expenses and the

amounts remained fairly constant from year to year except for minor variations such as salary adjustments. The amount of dividends from foreign subsidiaries varied, but the other gross income was fairly constant. R.47.)

The taxpayer has owned the shares of most of its subsidiaries for many years and does not buy and sell such shares (R. 47).

The amount of expenses is not related to the amount of dividends from foreign subsidiaries. Such dividends did not reflect earnings for the year in which paid. The taxpayer controlled the amount of dividends distributed to it by its subsidiaries. (R.47.)

Foreign taxes were withheld at the source, except in Sweden and Australia, where, pursuant to local law, the payors of the income filed returns on behalf of the taxpayer instead of withholding the tax (R. 47).

In determining the limitation upon the taxpayer's foreign tax credit under Section 131 (b) of the Revenue Acts of 1936 and 1938, the Commissioner determined the taxpayer's net income from sources without the United States by applying a part of the deductions, after adjustments irrelevant here, directly against gross income from within foreign countries, and a part directly against gross income from within the United States. The remainder of the deductions he treated as not directly allocable, and he applied

them ratably against gross income from within foreign countries and gross income from within the United States. (R. 46–47.)

The taxpayer maintained in the courts below (R. 51, 99) that of the deductions not directly allocable, no part should be applied against the dividends received by the taxpayer from foreign corporations.

The Tax Court rejected the taxpayer's contention (R. 49–52), and the Circuit Court of Appeals affirmed (R. 99–100).[2]

ARGUMENT

On the issue raised in the petition (pp. 8–9), the decisions below are correct and present no conflict.

Section 131 (b) of the Revenue Acts of 1936 and 1938 (Appendix A, *infra*, pp. 14–15), through the use of two fractions, limits the credit that may be taken by a taxpayer for taxes paid or accrued to foreign countries. In the second fraction the taxpayer's net income from sources without the United States is the numerator; the taxpayer's entire net income is the denominator. The credit for taxes paid or accrued to foreign countries may

[2] The opinions below also deal with the question, not pertinent here, whether deductions on account of certain royalty expenses paid by the taxpayer should be applied directly to certain items of income, or ratably to United States and foreign sources. On that issue, decided by the Tax Court in accordance with the Commissioner's contention there (R. 52–53), the Circuit Court of Appeals reversed (R. 100–101).

not exceed this fraction of the tax against which the credit is taken.

The taxpayer maintains that in arriving at the fraction, the dividends which it receives from foreign corporations are to be treated as an item of net income from without the United States, without any reduction on account of the taxpayer's expenses. If the fraction is so arrived at, the numerator is advantageously large for the taxpayer.

Under Section 131 (e) of the Revenue Acts of 1936 and 1938, credits for foreign taxes may be allowed only if the taxpayer establishes to the satisfaction of the Commissioner—[3]

> (1) the total amount of income derived from sources without the United States, determined as provided in section 119, * * *.

Under Section 119 (c) (Appendix A, *infra*, pp. 12–13) the following items of gross income are to be treated as income from without the United

[3] The taxpayer quotes a portion of clause (2) of Section 131 (e) and says that the decisions below make clause (2) redundant and ineffective (Pet. 6–7). If clause (2) is read in its entirety it will be seen to relate only to the method of determining what part of income from without the United States is derived from each foreign country. That allocation, necessary in computing the first fraction in Section 131 (b) (1), is left for regulations prescribed by the Commissioner, but the determination of the total amount of income from sources without the United States, necessary in computing the second fraction in Section 131 (b) (2), is governed by Section 119 (Appendix A, *infra*, pp. 11–14).

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States: (1) Interest other than from sources within the United States; (2) dividends other than those derived from within the United States; (3) compensation for labor or personal service performed without the United States; (4) gains, profits and income from the sale of real property located without the United States.

The method for determining net income from sources without the United States is prescribed by Section 119 (d). There are to be deducted from "the items of gross income specified in subsection (c)" the deductions properly apportioned or allocated thereto, "and a ratable part of any expenses * * * or other deductions which cannot definitely be allocated to some item or class of gross income."

The taxpayer does not assert that the deductions here in question can definitely be allocated to some item or class of gross income specified in subsection (c). Therefore, a ratable part must be deducted from all of the items of gross income there specified. "Dividends" is such an item. Hence dividends must bear their ratable share of general or non-identifiable expenses.

The taxpayer urges that the statute, thus read, is unfair in its application, inasmuch as the Tax Court found that the amount of expenses is unrelated to the amount of dividends from foreign subsidiaries (R. 47). Even though the two items are unrelated in amount, however, it is quite im-

possible to assume, as the taxpayer does, that none of the taxpayer's expenses are attributable to its receipt of the dividends; for example, the taxpayer incurs expenses for rent, accounting and clerical help (R. 50–51).[4] The statute is calculated to eliminate the difficult question of determining with precision what portion of such expenses should be ascribed to various sources of income.

The method of computation here used by the Commissioner comports with the plain meaning of the statute, and also with the text and example in Article 119–10 of Treasury Regulations 94 and 101 (Appendix A, *infra*, pp. 15–17). That Article, while it relates to the problem of determining net income from sources within the United States, plainly illustrates that under subsections (b) and (d) of Section 119, a ratable part of expenses which are not otherwise allocable must be allocated against gross income, including dividends. Example 3 in Article 131–8 of those Regulations Appendix A, *infra*, pp. 17–18, upon which the taxpayer relies (Pet. 3–4, note 1), is not concerned with the allocation of deductible losses and expenses to gross income—the problem here involved, and its bearing upon this problem, if any, is merely inferential.

[4] It should be noted that the court below held that where it was shown that expenses "bore no relation to the receipt of dividends," a ratable allocation should not be made (R. 101).

Because of the clear terms of the statute, the Circuit Court of Appeals found it impossible to sustain contentions of the taxpayer based upon some administrative practice in prior years and some indications in Treasury Form 1118 which seem to reflect a contrary interpretation of the statute. In rejecting the taxpayer's contentions in that regard, the decision below conforms to *Koshland* v. *Helvering,* 298 U. S. 441, and *American Chicle Co.* v. *United States,* 316 U. S. 450. Cf. *Eastman Kodak Co.* v. *United States,* 48 F. Supp. 357, 359 (C. Cls.).

CONCLUSION

The decisions below are correct and there is no conflict. The petition for writs of certiorari should be denied.

Respectfully submitted.

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